No. 14880

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

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In the Matter of

THE BRIDGFORD COMPANY, a Corporation,

Bankrupt.

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PAUL W. SAMPSELL, Trustee in Bankrupcty for the Estate of The Bridgford Company, a Corporation, Bankrupt,

*Appellant,*

*vs.*

HUGH H. BRIDGFORD,

*Appellee.*

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## APPELLANT'S OPENING BRIEF.

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This is an appeal from an order after hearing on motion to modify an order made by Honorable Ben Harrison, United States District Judge, on August 20, 1954, and on which prior order the appellant seeks a review and reversal as well as the amended order.

The appellant is the Trustee in Bankruptcy of the Bridgford Company, a corporation, bankrupt. The appellee is Hugh H. Bridgford, who was the president and a director and a major stockholder of the Bridgford Company, and during the bankruptcy was a court-appointed manager of the Bridgford Company. The real question involved here is whether Mr. Bridgford is going to be permitted to take advantage of his fiduciary position and obtain a substantial portion of the assets of his bankrupt corporation as against the interest of his creditors generally.

The appeal from the original order, although taken more than thirty days after its entry, is taken under the authority of *Wayne United Gas Co. v. Owens-Illinois Glass Co.,* 300 U. S. 131, for the reason that the District Court entertained the motion of the Trustee to reconsider and clarify the original order, and made a new order which was even more disastrous to the bankrupt estate than the original order. Hence this appeal.

## Jurisdiction.

The original jurisdiction of the Bankruptcy Court was invoked under Section 2-a, Subdivision 1 of the National Bankruptcy Act by the debtor filing its original voluntary petition under Chapter XI of the National Bankruptcy Act on April 25, 1947, and its subsequent adjudication by the Referee. The jurisdiction of this Court is invoked under Section 25-a of the National Bankruptcy Act.

## The Facts.

In outlining the facts in this case, we are taking as true, the facts found by the Referee, the original trier of fact, in connection with this controversy. The reversal by the District Judge is based purely on his conclusion that the Referee had erred in subordinating the claim of Hugh H. Bridgford, president of the bankrupt corporation, to the rights of creditors whose produce had enriched the estate during Bridgford's management under the supervision of the Bankruptcy Court, and a substantial portion of the proceeds of which went to Bridgford after he had learned that the Referee was going to adjudicate The Bridgford Company a bankrupt. We submit that the Referee was right and the District Judge erred both in overruling the Referee on the question of subordination and in according this unfaithful officer a position of priority over claims accrued on or before February 2, 1948, and placing it in a priority over claims accruing on or after February 3, 1948, and later by his Order dated May 23, 1955, giving the Bridgford claim priority over all claims and indebtedness whether incurred or occurring either before or after February 2, 1948 (except administrative costs and expenses).

On April 25, 1947, The Bridgford Company filed a voluntary petition in the United States District Court for the Southern District of California, Southern Division, seeking relief under Chapter XI. The debtor was permitted to remain in possession of its assets, the Court retaining jurisdiction until the consummation of the Plan. [See Referee's Certificate on Review, R. p. 130.] One of the Court-appointed managers in charge of the bankrupt's assets and funds was the Appellee, Hugh H. Bridgford. Bridgford was president of the debtor corporation. [See Findings of Fact, Conclusions of Law, etc., R. p. 113.]

During the course of administration under Chapter XI, the Bankruptcy Court authorized the issuance of $30,000.00 worth of Receiver's or Debtor's certificates[1] which

[1]In this brief these certificates may be referred to interchangeably as "Receiver's" Certificates and "Debtor's" Certificates. Both designations refer to the same evidence of debt.

were purchased by one R. H. Hadley. [See Referee's Findings of Fact, etc., Finding II, R. p. 111.] These certificates were not a lien against the assets of the debtor's estate but were given priority in payment as against indebtedness existing at the time of their issue. [See Finding III, R. p. 111.]

On or about July 8, 1949, a petition was filed by three creditors requesting the adjudication of The Bridgford Company as a bankrupt, or a dismissal of the proceedings under Chapter XI. [See Finding VI, R. p. 112.] Hearings were had on this petition and concluded on November 4, 1949. The Court announced that it was going to find the debtor in default under its Plan of Arrangement, and that it would order an adjudication in bankruptcy. This announcement was made in the presence of the Appellee and the other Court-appointed managers. [See Finding VI, R. p. 112.]

After the adjournment of the hearing at which the Referee announced his intention to adjudicate the debtor a bankrupt, Bridgford proceeded to protect himself in connection with the payment of these debtor's certificates. Owing to the intervention of a week end it took three days or more for the preparation of a formal written order of adjudication, but in the meantime respondent Bridgford was anything but idle. On November 7, 1949, he presented a petition for an order authorizing him to pay out the funds represented by the debtor's certificates theretofore issued, on which there remained a balance of $25,996.40 principal and interest. [See Finding VIII,

R. p. 115.] He failed to disclose to the Referee that he had acquired these debtor's certificates gratis, and the Referee, being deceived by Bridgford's concealment of facts, to which he owed the Court a disclosure, signed an order authorizing their payment. [See Finding IX, R. p. 114.] Had the Referee been informed that Bridgford, president of the bankrupt corporation and a trusted officer of the Court, had acquired these certificates without paying anything for them, he would never have signed the order authorizing their payment. [See Finding IX, R. p. 114.] The order of adjudication was entered on November 8, 1949. Paul W. Sampsell was appointed Trustee, and upon ascertaining the fact that the president of the debtor in possession had paid himself in full on debtor's certificates acquired by him for nothing, and out of money accumulated in the estate from the proceeds of processed raw materials purchased from farmers and unpaid for, sought by appropriate petition to get the money back from Bridgford. [See Findings IX, X and XI, R. pp. 114-116, incl.] When Bridgford got through paying himself and a few others he had left, in this grossly insolvent estate the small sum of $60.00. [See Finding VII, R. p. 113.] Mr. Sampsell, as Trustee, inherited expenses of administration, liabilities to various Oregon farmers for produce purchased during the Chapter XI proceedings, amounting to $100,000.00 or more, in addition to the liabilities owed prior to the filing of the voluntary petition. [See Finding XII, R. p. 116.]

The turnover proceeding directed against Bridgford came on for hearing commencing June 12, 1953, after a trial before the Referee, and findings of fact and conclusions of law and a turnover order against Hugh Bridgford were entered. The order provided that Bridgford be allowed a general claim against the bankrupt estate in the sum of $30,000.00 upon repayment by him to the bankrupt estate of the sum of $25,996.40 which he had paid himself, his claim, however, to be subordinated to the payment of all claims and indebtedness against the bankrupt estate, including the expenses of administration. [See findings of fact, conclusions of law and order after hearing on objections of trustee to claim of Hugh H. Bridgford for $30,000.00, R. p. 110, *et seq.*] Bridgford, feeling aggrieved by the Referee's order, took a review. Originally, the review was before Judge Jacob Weinberger at San Diego, but because of calendar conditions, was heard and determined by Judge Ben Harrison. The order of the Referee requiring Bridgford to turn over his ill-gotten gains and subordinating his claims was modified by the District Judge, and no appeal was taken from that order by the Trustee. The order, however, was somewhat vague, and the Trustee, being in doubt as to just what course he should pursue, filed a petition with the Judge seeking clarification and modification of the original order in question. [R. p. 145 *et seq.*] The Court entertained the Trustee's petition, heard argument thereon, and proceeded to modify the order in a more drastic manner than before. [R. p. 148.] In the modified order, the District Court accorded priority to the claim of Bridgford over all claims and indebtedness (including the claims of the Oregon farmers) excepting, however, the fees, costs and expenses of administration. The Trustee took his appeal within thirty days after the entry of the second order which superseded and modified the original.

## ARGUMENT POINTS AND AUTHORITIES.

The first question which will naturally arise is whether or not the appeal taken from the District Court's order after hearing on motion to modify order on review will encompass the original order entered by the District Court on August 20, 1954. We submit that it does. The order of August 20, 1954, modifying the Referee's order, left a doubt as to the disposition or status of Bridgford's claim. The Trustee filed a motion to clarify and correct findings of fact, conclusions of law and order modifying order of Referee. The District Court set the matter for hearing and heard it on April 11, 1955. Thereafter, he made his order after hearing on motion to modify order on review, placing Bridgford's claim in a prior position to all claims and indebtedness incurred after February 3, 1948, including the claims of the Oregon farmers. The Trustee took a timely appeal from this order, and we submit that under the rule laid down by the Supreme Court of the United States in *Wayne United Gas Company v. Owens-Illinois Glass Co.,* 300 U. S. 131, 81 L. Ed. 557, the appeal from the clarified order was timely, and the Trustee's time to appeal was tolled. We quote from the Supreme Court's decision in the *Wayne United Gas Company* case (at p. 561):

> "On the contrary, the rule which governs the case is that the bankruptcy court, in the exercise of a sound discretion, if no intervening rights will be prejudiced by its action, may grant a rehearing upon application diligently made and rehear the case upon the merits; and even though it reaffirm its former action and refuse to enter a decree different from the original one, the order entered upon rehearing is appealable and the time for appeal runs from its entry. The District Court's action conformed to

these conditions. Two days after the Circuit Court of Appeals dismissed the petition for allowance of appeal from the original order of March 2, 1936, petitioner notified respondents of its intention to apply for rehearing. Prompt application was made and the cause was promptly heard. A supplemental petition was presented and entered upon the files by leave of court. The original, the amended, and the supplemental petition were considered upon the merits, and the court made findings and announced conclusions of law with respect thereto. There is no indication that the petition for rehearing was not made in good faith or that the court received it for the purpose of extending petitioner's time for appeal. The court found that no rights had intervened which would render it inequitable to reconsider the merits. There was no abuse of sound discretion in granting the motion and reconsidering the cause.

"The judgment is reversed and the cause is remanded to the Circuit Court of Appeals for further proceedings in conformity to this opinion.

"Reversed."

The Supreme Court based its ruling, that the time for appeal ran from the entry of the subsequent order on rehearing, on the following authorities under footnote 13:

"Compare Aspen Min. & Smelting Co. v. Billings, *supra* (150 U. S. p. 37, 37 L. ed. 988, 14 S. Ct. 4); Voorhees v. John T. Noye Mfg. Co., *supra* (151 U. S. p. 137, 38 L. ed. 102, 14 S. Ct. 295); Citizens Bank v. Opperman, 249 U. S. 448, 450, 63 L. ed. 701, 702, 39 S. Ct. 330; Morse v. United States, *supra* (270 U. S. p. 154, 70 L. ed. 519, 46 S. Ct. 241)."

**The Appellee, Hugh H. Bridgford, Was Guilty of Faithless Conduct Both as an Officer of the Bankrupt Corporation and as Debtor in Possession Appointed by the Bankruptcy Court, and the Referee Was Correct in Requiring Him to Pay Back the Money He Had Appropriated Unto Himself and to Subordinate His Claim to All Claims and Indebtedness, Including Costs and Expenses, of Said Bankrupt Estate.**

We believe that the conduct of Mr. Bridgford was reprehensible in the extreme and deserved condemnation on the part of the District Court rather than permitting him to have a position of priority over the Oregon farmers. Bridgford was president of the bankrupt corporation. As such he was permitted by the Bankruptcy Court to function as debtor in possession under Chapter XI of the Bankruptcy Act, Section 342.

Under Section 1911 of 18 U. S. C. A. he was required under sanction of criminal penalties to operate the property in his possession in accordance with the requirements of valid laws of the State in which the property was situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof. A portion of the property in question was located in the State of California, and the bankrupt was and is a corporation doing business in the State of California. Bridgford was therefore required under Section 1911 of 18 U. S. C. A. to manage the property under his control in accordance with the law of California. What restrictions were placed upon him both as an officer of the bankrupt corporation and an officer of the Bankruptcy Court? That Bridgford in his capacity as manager for the debtor in possession was an officer of the Court cannot be gainsaid.

Under Section 343 of Chapter XI, he had the right and power, subject to the control of the Court, to operate the business and manage the property of the debtor during such period, limited or indefinite, as the Court might from time to time fix.

As far back as 1856, the Supreme Court of California laid down definite rules governing the conduct of persons in a fiduciary capacity.

In *Page v. Naglee,* 6 Cal. 241, at 245, the Supreme Court said:

> "It is a familiar principle in law, that one who is a trustee, or who stands in a situation of trust and confidence, cannot purchase or deal with the subject of the trust, neither can he purchase debts due, to be paid out of the trust estate, nor place himself in an attitude of antagonistic to the trust. The purchase by the defendant of the one thousand dollars indebtedness of Page, Bacon & Co., and the judgment obtained in the name of S. C. Hastings, if not a fraud in fact, was in violation of his duties as a trustee of said firm, and it makes no difference in this respect, whether the instrument conveying the property to himself and Parrott was a deed of trust or mortgage, or whether the same was void or not."

Following this comes a long line of decisions of the Supreme Court of California, which rigidly circumscribe the rights of a fiduciary to acquire property entrusted to him or to purchase claims against his trust at a discount and enforce such claims for the full amount. In the case of *Bonney v. Tilley,* 109 Cal. 346, the Supreme Court of California, quoting from Cook on Stock and Stockholders, Section 660, incorporated this principle into its decision:

> "In Cook on Stock and Stockholders, section 660, it is said: 'It is a fraud on the corporation and on

corporate creditors for the directors to buy up at a discount the outstanding debts of the corporation and compel it to pay them the full face value thereof. In such a case the directors may be compelled to turn over to the corporation the evidences of indebtedness upon being paid the money which they gave for the same.' "

In *Wickersham v. Crittenden,* 93 Cal. 17, the Supreme Court of California said (at p. 29):

> "The directors of a corporation hold a fiduciary relation to the stockholders, and have been intrusted by them with the management of the corporate property for the common benefit and advantage of each and every stockholder, and by their acceptance of this office they preclude themselves from doing any act or engaging in any transaction in which their private interest will conflict with the duty they owe to the stockholders, and from making any use of their power or of the corporate property for their own advantage. (Cook on Stocks and Stockholders, sec. 648; Morawetz on Private Corporations, sec. 516; Cumberland Coal Co. v. Sherman, 30 Barb. 571; Hoyle v. Plattsburgh & M. R.R. Co., 54 N. Y. 328; 13 Am. Rep. 598; Barnes v. Brown, 80 N. Y. 535; San Diego v. San Diego etc. R.R. Co., 44 Cal. 106; Wilbur v. Lynde, 49 Cal. 290, 19 Am. Rep. 645; Farmers' etc. Bank v. Downey, 53 Cal. 466, 31 Am. Rep. 62.) For the reason that it is against public policy to permit persons occupying fiduciary relations to be placed in such a position that the influence of selfish motives may be a temptation so great as to overpower their duty and lead to a betrayal of their trust, the rule is unyielding that a trustee shall not, under any circumstances, be allowed to have any dealings in the trust property with himself, or ac-

quire any interest therein. Courts will not permit any investigation into the fairness or unfairness of the transaction, or allow the trustee to show that the dealing was for the best interest of the beneficiary, but will set the transaction aside, at the mere option of the *cestui que trust.* (Story's Eq. Jur., sec. 322; Davoue v. Fanning, 2 Johns. Ch. 252; Taussig v. Hart, 58 N. Y. 428; Elevated R.R. Case, 11 Daly 486; Michoud v. Girod, 4 How. 503; Davis v. Rock Creek, 55 Cal. 364; 36 Am. Rep. 40.) 'So strictly is this principle adhered to, that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into. It obviously is or may be impossible to demonstrate how far, in any particular case, the terms of such a contract have been the best for the interest of the *cestui que trust* which it was possible to obtain. It may sometimes happen that the terms on which a trustee has dealt, or attempted to deal, with the estate or interests of those for whom he is a trustee have been as good as could be obtained from any other person; they may even at the time have been better, but still, so inflexible is the rule that no inquiry on that subject is permitted.' (Aberdeen R'y Co. v. Blaikie, 1 Macq. 461.) It is declared in the Civil Code, sec. 2229: 'A trustee may not use or deal with the trust property for his own profit, or for any other purpose unconnected with the trust in any manner.' "

Again in *Pacific Vinegar and Pickle Works v. Smith,* 145 Cal. 352, the Court said:

"These authorities lay down two propositions: 1. That an expressed contract cannot be entered into by a director with himself relative to the trust property; and 2. That the court will not permit any inquiry into the question of the honesty or fairness of the transaction.

"The philosophy of this rule is quite apparent, and its inflexibility is the strongest safeguard which the law can offer for the protection of the interests of the beneficiary. The great purpose of the law is to secure fidelity in the agent. When one undertakes to deal with himself in different capacities—individual and representative—there is a manifest hostility in the position he occupies. His duty calls upon him to act for the best interests of his principal; his self-interest prompts him to make the best bargain for himself. Humanity is so constituted that when these conflicting interests arise, the temptation is usually too great to be overcome, and duty is sacrificed to interest. In order that this temptation may be avoided, or, if indulged in, must be at the peril of the trustee, it has been wisely provided that the trustee shall not be permitted to make or enforce any contract arising between himself as trustee and individually with reference to any matter of the trust, nor will the court enter into any examination of the honesty of the transaction."

In the *Pacific Vinegar Works* case, the Supreme Court of California based its condemnatoin of a fiduciary dealing with trust property on behalf of himself on the following California cases:

*Davis v. Rock Creek etc. Mining Co.,* 55 Cal. 359;
*Sims v. Petaluma Gas Co.,* 131 Cal. 659;
*Aberdeen Ry. Co. v. Blakie,* 1 Macq. H. L. 461;
*Munson v. Syracuse etc. R.R. Co.,* 103 N. Y. 74.

Summarzing on page 366 of the Opinion, the Court said:

"So harmonious is the law on this subject that authorities might be cited indefinitely, but reference is made only to those in this state where the principles have been discussed, reiterated, and approved."

The Court then proceeds to cite eleven more cases in support of the principle, with which we will not burden this Court.

See also:

*Estate of Howard,* 284 P. 2d 966.

In the case at Bar, Bridgford acquired these debtors' certificates for nothing. His duty as a fiduciary required under the rule laid down in *Bonney v. Tilley,* 109 Cal. 346, at 352, that he turn over to the estate these evidences of indebteness, instead of hastily procuring the countersignature of the Referee on a check to him for the full amount, without disclosing to the Referee that he had acquired these certificates which he sought to enforce against the estate, without any consideration whatsoever.

Nor are the Federal Courts one whit more tolerant toward such dealings.

In the *Matter of the Van Sweringen Company,* 119 F. 2d 231 (C. A. 6th), in cutting down a claim asserted by the Van Sweringen Brothers from $8,177,023.99 to the amount of $1.00 plus interest, and another claim of $13,787,000.00 to $887.00 plus interest, and a third claim for $1,348,614.99 to $2.00 plus interest, the Court said:

> "We think the District Court correctly held that the 'Midamerica Corporation acquired and holds these notes, bonds and securities as Trustee for the respective debtors whose obligations or assets they were,' and that 'the amounts paid for the notes and bonds measure the extent of its claims against these debtors.'
>
> "From the manner and under the circumstances in which, in association with outside enterprisors, the

Van Sweringens, as directors of insolvent corporations, purchased these claims against their *cestui que trustent,* the debtors, herein, at substantially less than real values, equity and good conscience demand that the claims of their corporate creature, Midamerica (predecessor to appellant), be limited to the amounts actually paid by it for the notes and bonds of the insolvent corporations. See, Bonney v. Tilley, 109 Cal. 346, 42 P. 439; *In re* McCrory Stores Corporation, D. C., 12 F. Supp. 267; Farwell v. Pyle-National Electric Headlight Co., 289 Ill. 157, 124 N. E. 449, 10 A. L. R. 363; Lingle v. National Insurance Co., 45 No. 109; Canton Roll & Machine Co. v. Rolling Mill Co., 4 Cir., 168 F. 465; Higgins v. Lansingh, 154 Ill. 301, 40 N. E. 362; Lonsdale v. Speyer, 1936, 249 App. Div. 133, 291 N. Y. S. 495; Lomita Land & Water Co. v. Robinson, 154 Cal. 36, 97 P. 10, 18 L. R. A., N. S. 1106.

"As expressed by Chief Judge Cardozo in Meinhard v. Salmon, 249 N. Y. 458, 464, 164 N. E. 545, 546, 62 A. L. R. 1: 'Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of the courts of equity when petitioned to undermine the rule of undivided loyalty by the "distintegrating erosion" of particular exceptions . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.' We uphold the standard of this doctrine. . . .

> "Where the directors of a corporation, contrary to their fiduciary duty, have made a personal profit in their dealings with the corporation, equity will compel them to account to the corporation for such profits made at its expense. . . .
>
> "It is apparent here that the cupidity of persons in a fiduciary position has caused them to serve themselves in preference to those whom it was their duty to serve. Such dereliction is forbidden by just principles of law."

Also, in the case of *Los Angeles Lumber Products Co.,* 46 Fed. Supp. 77, Judge Jenney of this District, held that the recovery on bonds purchased by a fiduciary of the corporation during insolvency should be limited to the amount actually paid therefor. (To the same effect see: *Canton Roll & Machine Co.,* 168 Fed. 465; *Martin v. Chambers,* 214 Fed. 769.)

On the subject of subordination of claims of officers, directors and stockholders, and the equitable powers of the bankruptcy court in connection therewith, the Supreme Court of the United States, in the case of *Pepper v. Litton,* 308 U. S. 295, 60 S. Ct. 238, speaking through Justice Douglas, said:

> "That equitable power also exists in passing on claims presented by an officer, director, or stockholder in the bankruptcy proceedings of his corporation. The mere fact that an officer, director, or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord its *pari passu* treatment with the claims of other creditors. Its disallowance or subordination may be necessitated by certain cardinal principles of equity jurisprudence. A director is a fiduciary. Twin-Lick

Oil Company v. Marbury, 91 U. S. 587, 588. So is a dominant or controlling stockholder or group of stockholders. Southern Pacific Company v. Bogert, 250 U. S. 483, 492. Their powers are powers in trust. See Jackson v. Ludeling, 21 Wall. 616, 624. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. Geddes v. Anaconda Copper Mining Company, 254 U. S. 590, 599. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside. While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.

"As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy. In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder. That is clearly the power and duty of the bankruptcy courts under the reorganization sections. In Taylor v. Standard Gas & Electric Co., 306 U. S. 307, 38 Am. B. R. (N. S.) 692, this court held that the claim of Standard against its subsidiary (admittedly a claim due and owing) should be allowed to participate in the reorganization plan of the subsidiary only in subordination to the preferred stock of the subsidiary. This was based on the equities of the case—the history of spoliation, mismanagement, and faithless stewardship of the affairs of the subsidiary by Standard to the detriment of the public investors. Similar results have properly been reached in ordinary bankruptcy proceedings. Thus, salary claims of officers, directors and stockholders in the bankruptcy of 'one-man' or family corporations have been disallowed or subordinated where the courts have been satisfied that allowance of the claims would not be fair or equitable to other creditors. And that result may be reached even though the salary claim has been reduced to judgment. It is reached where the claim asserted is void or voidable because the vote of the interested director or stockholder helped bring it into being or where the history of the corporation shows dominancy and exploitations on the part of the claimant."

Again, in the case of *Sampsell v. Imperial Paper & Color Corporation,* 313 U. S. 215, 45 A. B. R. (N. S.) 454, the court said:

"The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete." (Citing authorities.)

The authorities on this subject are so voluminous and the law is so well established that it seems unnecessary to impose on the time of the court by citing additional authorities on this point.

The most recent case before this Court involving employees of the Bankruptcy Court is the case of *Donovan & Schuenke, et al. v. Sampsell, as Trustee, et al.,* 226 F. 2d 804. In that case, one D. J. Miller was president of Ridgecrest Development Co., a bankrupt. In the course of the administration, he procured an order from the Referee in charge of the proceeding, authorizing him, in the interests of economy of administration, to collect rents on certain income properties belonging to the bankrupt estate, and remit them to the Trustee. He was to receive a small compensation for this work. When the property came up for sale in open Court, he asked the Referee if there would be any objection to his making a bid or becoming a purchaser. The Referee, with knowledge that Miller had done some work for the bankrupt estate, saw no reason why Miller's money was not as good as anyone else's, and permitted him to make a bid. Miller was the successful high bidder and the sale was confirmed to him. The time to review the order of confirmation expired, and several months thereafter certain creditors of the bankrupt corporation and certain stockholders attacked the sale as being void and in violation of Section 154 of Title 18, U. S. C. A. The Referee denied the petition of the creditors and stockholders seeking to set the sale aside and was affirmed by the District Court. On appeal to this Court, the orders of the District Judge and of the Referee were reversed and the sale held to be null and void.

In reversing the District Court and the Referee, Judge Fee of this Court, in quoting from *Pepper v. Litton,* 308 U. S. 295 at 306, said:

> "Once a corporation is adjudged a bankrupt, the equitable powers of the court are used in accordance with considerations of public policy, which are deeply grounded upon fundamental principles. There the obligations of an officer or director of a corporation to the stockholders and creditors often require drastic measures. As was said by Mr. Justice Douglas in Pepper v. Litton, 308 U. S. 295, 306:
>
> " 'A director is a fiduciary. * * * So is a dominant or controlling stockholder or group of stockholders. * * * Their powers are powers in trust. * * * While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation-creditors as well as stockholders.' "

The opinion of this Court was based largely on *Mosser v. Darrow,* 341 U. S. 266, 95 L. Ed. 927. In that case Darrow, as Trustee, was surcharged by the United States District Court for the Eastern District of Illinois in the sum of $43,447.46. The surcharge was based on the fact that Darrow, as Trustee, had employed Jacob Kulp and Myrtle Johnson, who thoroughly knew the inside of the business of the bankrupt's common law trusts. When he employed them he had an understanding with them that they would be permitted to speculate in the securities of the bankrupt. In the course of the administration they purchased numerous bonds at a substantial discount and retired them in the bankruptcy proceeding at profits to themselves in excess of $40,000.00. Darrow claimed to have discussed the matter of their activities with District Judge Holly, but did not disclose to the District Judge that he was employing these people on terms which permitted trading in the underlying securities. The Court of Appeals for the Seventh Circuit reversed the order surcharging the Trustee, basing its decision on the fact that the Trustee himself had not personally made a profit out of the transactions of his subordinates. The United States Supreme Court granted certiorari and reversed the Seventh Circuit. We quote from this opinion written by Justice Jackson, as follows:

> "This was a strict trusteeship, not one of those quasi-trusteeships in which self-interest and representative interests are combined. A reorganization trustee is the representative of the court and it is not contended and would not be arguable that if he had engaged for his own advantage in the same transactions that he authorized on the part of his subordinates he should not be surcharged. Equity tolerates in bankruptcy trustees no interest adverse to the trust. This is not because such interests are always corrupt but because they are always corrupting. By its exclusion of the trustee from any personal interest, it seeks to avoid such delicate inquiries as we have here into the conduct of its own appointees by exacting from them forbearance of all opportunities to advance self-interest that might bring the disinterestedness of their administration into question.
>
> "These strict prohibitions would serve little purpose if the trustee were free to authorize others to do what he is forbidden. While there is no charge of it here, it is obvious that this would open up op-

portunities for devious dealings in the name of others that the trustee could not conduct in his own. The motives of man are too complex for equity to separate in the case of its trustees the motive of acquiring efficient help from motives of favoring help, for any reason at all or from anticipation of counter favors later to come. We think that which the trustee had no right to do he had no right to authorize, and that the transactions were as forbidden for benefit of others as they would have been on behalf of the trustee himself."

Further on the Court said:

"But equity has sought to limit difficult and delicate fact-finding tasks concerning its own trustee by precluding such transactions for the reason that their effect is often difficult to trace, and the prohibition is not merely against injuring the estate—it is against profiting out of the position of trust. That this has occurred, so far as the employees are concerned, is undenied."

In *In re Frazin & Oppenheim,* 181 Fed. 307, the Court of Appeals for the Second Circuit, in reversing an order of the United States District Court for the Southern District of New York, which confirmed a sale made of bankrupt's assets to one of the appraisers through a third party, said:

"It is a long-established principle of equity jurisprudence that a trustee cannot become a purchaser of the trust estate. And not only trustees, strictly speaking, but agents, attorneys, and all persons acting in behalf of other persons and obtaining confidential information concerning their affairs, cannot purchase their property, except under certain restraints not necessary to be considered here. Lord

St. Leonards thus stated these elementary principles in his treatise on Vendors and Purchasers (Sugden on Vend. and Purch. (2d Am. Ed. from 5th London Ed.), p. 422), and his statement has many times been quoted with approval by judges and text-writers:

" 'It may be laid down as a general proposition that trustees, unless they are nominally so, as trustees to perserve contingent remainders, agents, commissioners of bankrupts, assignees of bankrupts, solicitors to the commission, auctioneers, creditors who have been consulted as to the mode of sale, or any persons who, by their connection with any other person, or by being employed or concerned in his affairs, have acquired a knowledge of his property, are incapable of purchasing such property themselves, except under the restrictions which will shortly be mentioned; for, if persons having a confidential character were permitted to avail themselves of any knowledge acquired in that capacity, they might be induced to conceal their information, and not to exercise it for the benefit of the persons relying upon their integrity. The characters are inconsistent. *"Emptor emit quam minimo potest, venditor vendit quam maximo potest."* '

"The application of these principles is not dependent upon the engagement of one person by another in a confidential capacity. There need be no contract of employment at all. There need be no formal relation of trust. The disability grows out of the duty. In our opinion the rule of equity should be so broadly applied as to embrace all persons who have a duty to perform with respect to the property of others and with the proper performance of whose duty the character of a purchaser of such property may be in any degree inconsistent."

Bearing in mind that appellee hastily prepared a petition and order for disbursement of all funds in the debtor in possession's hands, with the exception of approximately $60.00, after the Referee had announced at his hearing on November 4, 1949, that he had found the debtor in default and would order an adjudication, and wedged this petition and order in between November 4 and November 7, when the formal order of adjudication could be entered, thus securing payment to himself of his debtor's certificates, we cannot refrain from quoting some of the pungent language used by the Court in condemning activities of those who are on the "inside" to secure advange to themselves while in a trust or fiduciary capacity. The staccato language used by Justice Douglas in *Pepper v. Litton,* vividly describes the disabilities placed upon an "insider" in dealing with his trust. We quote (at p. 284):

> "He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of the privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be

> exercised for the aggrandisement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis.* Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation."

We also quote from the language of the Second Circuit in *In re Frazin & Oppenheim,* 181 Fed. 307 at 310:

> "The nature of the position of an appraiser is such that he necessarily obtains confidential information concerning many other matters affecting its value and the price to be obtained for it. His duty is to appraise it at a fair and reasonable value, for, if it is sold not subject to the approval of the court, only such an appraisal will afford protection to the estate. But a report of the value of the property to be sold, made by a prospective bidder for it, could hardly be considered a reliable guide for the action of the court. Would an appraisal be implictly relied upon in which the appraiser reported that the property was of the value of $16,000, but that he had entered into an agreement to bid $40,000 for it?"

In the case at Bar, this appellee functioning on behalf of a corporation as debtor in possession had incurred, in the administration under Chapter XI, an indebtedness to the Oregon farmers for produce in a sum in excess of $100,000.00. His inside information as an officer of the Court enabled him to know the amount of indebtedness incurred during the administration, the intention of the Referee to adjudicate the corporation a bankrupt, the outstanding debtor's certificates in the possession of Hadley, the willingness of Hadley to convey these debtor's certificates without consideration to the appellee on the eve of his going to the hospital. [See testimony of R. H. Hadley, R. pp. 164, 166, 167 and 169, and testimony of

Hugh H. Bridgford, R. pp. 178 and 179.] He directed his attorneys to prepare a petition including payment to him of funds out of the estate at that time, and verified the same and presented it promptly to the Referee in order to obtain the necessary order. All of this was accomplished in three days time. Supposing instead of his having been a trusted functionary of the Bankrupcty Court there had been a Receiver in Bankruptcy, holding office at that time, and Bridgford had desired payment to him of these debtor's certificates. Supposing there had been a distinterested and impartial attorney representing the Receiver. Supposing that Bridgford had gone to the Receiver with debtor's certificates originally issued to Hadley and demanded payment in full with interest at once. Naturally, a conscientious Receiver (or his attorney) would inquire of Bridgford, president of the debtor corporation, how it happened that he was in possession of Hadley's debtor's certificates, what consideration he had paid therefor, whether or not he owed a duty to the debtor corporation to give it the advantage of the discount at which he had acquired these certificates, and would no doubt have said, "Hold it for a few days until we know just where we all stand. What's the rush? A few days delay in payment will not make any material difference." Facts underlying this sordid transaction could then have been exposed to the light of day, with the result that Bridgford would have received exactly what he paid Hadley for these debtor's certificates—nothing. Instead, we have a situation where, utilizing his inside position, Bridgford was able to have his personal attorney, who represented him in this proceeding, prepare a petition for immediate payment, present it to the Referee, procure an order for payment to him of these certificates, prepare a check for the debtor's certificates in full, payable to himself and procure the Referee's counter-signature thereon without disclosing to the Referee that he had obtained these certificates at a discount of 100%. In the meantime, the unfortunate farmers in Oregon who had furnished the raw material out of which the funds so disbursed had been realized, not being on the inside, as was Mr. Bridgford, now find themselves placed behind him in the distribution of the funds of this insolvent estate. A clearer case of breach of a fiduciary relationship could not be imagined. It may be true that had Hadley retained these certificates he would have been entitled to payment in full. In the hands of Bridgford, as assignee thereof, any realized profit should, under the principles repeatedly enunciated by the Courts, have accrued for the benefit of the bankrupt estate or the corporation of which Mr. Bridgford was and is president. (*Bonney v. Tilley,* 109 Cal. 346.)

The Referee was correct in subordinating Bridgford's claim to the claims of those creditors who had sold produce to the bankrupt corporation during the term of management under the Bankruptcy Court's supervision, and whose produce had created the fund out of which Bridgford paid himself, and the District Judge erred in placing Bridgford's claim in a superior position to these defrauded Oregon farmers.

During Bridgford's administration of this bankrupt estate, it incurred liabilities in the operation of the business to certain Oregon farmers in an amount in excess of $100,000.00. [See Referee Finding of fact XII, R. p. 116.]

On November 4, 1949, after a hearing at which it had been demonstrated that the Chapter XI administration was a failure, the Referee announced that he was going to adjudicate the Bridgford Company a bankrupt. Bridgford immediately swung into action to feather his own individual nest. He procured the outstanding debtor's certificates from R. H. Hadley without any consideration whatsoever, and three days later on November 7, 1949, before a formal order of adjudication could be prepared and entered, he presented to the Referee a petition for payment as a prior claim of the certificates of indebtedness, and without informing the Referee that he had obtained these certificates gratis, issued a check payable to himself and procured the Referee's counter-signature thereon. [See Referee Findings VII, VIII and IX, R. pp. 113-114.] As found in Finding VII, Bridgford's payment to himself and a few others left the estate with the sum of $60.00 balance on hand, and the Oregon farmers holding the proverbial sack.

In *Northtown Theatre Corporation v. Michelson*, 226 F. 2d 212, the Court of Appeals for the Eighth Circuit said:

> "The legality of a claim from a purely technical aspect does not preclude its disallowance or subordination on equitable grounds. The bankruptcy court in passing on claims sits as a court of equity. It has the power to disallow or subordinate claims in the light of equitable considerations and can sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the bankrupt estate. This power exists as a matter of the Federal law of bankruptcy."

In *United States Trust Company v. Zelle, et al.*, 191 F. 2d 822 at 825, the Eighth Circuit said:

> " 'It is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receiver-

ship and reorganization has been a balance of equities between creditor and creditor or between creditors and the debtor. * * * That the proceeding before us has moved from equity receivership through Section 77B to Chapter X (11 U. S. C. A., Secs. 207, 501 *et seq.*) in the wake of statutory change does not make these equitable considerations here inapplicable. A Chapter X or Section 77B reorganization court is just as much a court of equity as were its statutory and chancery antecedents.' 329 U. S. *loc. cit.* 165, 67 S. Ct. *loc. cit.* 241."

See also:

*Pepper v. Litton,* 308 U. S. 295;

*Sampsell v. Imperial Color & Paper Corp.,* 313 U. S. 213;

*Geddes v. Anaconda Copper Mining Co.,* 254 U. S. 590 at 599.

The only reimbursement that Bridgford would be entitled to would be the actual amount paid for these debtor's certificates. If he had purchased them for $1.00, that would have been the extent of his claim. Having obtained them for nothing, he was entitled to nothing in the face of creditors' claims.

See:

*In re Los Angeles Lumber Products Co.,* 46 Fed. Supp. 77.

In condemning conduct somewhat similar to the conduct of Bridgford in the case at Bar, United States District Judge Ford, in the *Matter of Wesley Corporation,* 18 Fed. Supp. 347 at 355, said:

"By long-established principles of equity jurisprudence, nothing is more clearly established than that a trustee may not become the purchaser of the trust estate either directly or through agents or other persons acting in his behalf. Both creditors and bankrupt alike have the right to expect that the trustee will not use his official position to speculate for his personal profit in the property entrusted to his care. The duty to enforce these principles rests no greater upon any courts than upon the federal courts of bankruptcy. The prime object of Congress in enacting the bankruptcy laws was to secure for creditors as well as bankrupts the efficient and fair administration of estates. *In re* Frazin & Oppenheim (C. C. A.), 181 F. 307; *In re* Allen B. Wrisley Company (C. C. A.), 133 F. 388; *In re* Hawley (D. C.), 117 F. 364; Remington on Bankruptcy, Sec. 2560. It is not important whether the price paid at the sale was adequate in a particular instance. The rule rests upon vital considerations of public policy and is applicable in every case. If the facts alleged in this amendment be true, the duty of the court to require the trustee to account for all proceeds derived from the property, including any profits from its resale, is clear and imperative."

The opinion of the late District Judge Ralph E. Jenney, *In re Los Angeles Lumber Products Co., Ltd.*, 46 Fed. Supp. 77, is a far more complete brief of the law relating to fiduciaries than the writer of this brief could ever hope to write. The opinion is approximately 17 pages long, but we respectfully commend it to the attention of this Court. We quote just one paragraph which Judge Jenney took from *Brambett v. Commonwealth Land & Lumber Co.*, 26 Ky. Law Rep. 1176, 83 S. W. 599-602:

" 'When he (the receiver) agreed with Smith and Wilson to join in the purchase if Wilson should become the successful bidder, he placed himself in a position in which his personal interests were, or might be, antagonistic to those of his trust. Michoud v. Girod (45 U. S. 503), 4 How. 503, 552, 11 L. Ed. 1076. It became to his personal interest that the purchase should be made by Wilson for the lowest possible price. The course taken was one which a fiduciary could not legally pursue. Magruder v. Drury, 235 U. S. 106, 119, 120, 35 S. Ct. 77, 59 L. Ed. 151. Since he did pursue it and profits resulted the law made him accountable to the trust estate for all the profits obtained by him and those who were associated with him in the matter, although the estate may not have been injured thereby. Magruder v. Drury, 235 U. S. 106, 35 S. Ct. 77, 59 L. Ed. 151. And others who knowingly join a fiduciary in such an enterprise likewise become jointly and severally liable with him for such profits. Emery v. Parrott, 107 Mass. 95, 103; Zinc Carbonate Co. v. First National Bank, 103 Wis. 125, 134, 79 N. W. 229, 74 Am. St. Rep. 845; Lomita Land & Water Co. v. Robinson, 154 Cal. 36, 97 P. 10, 18 L. R. A. (N. S.) 1106. Wilson and Smith are therefore jointly and severally liable for all profits resulting from the purchase; the former although he had no other relation to the estate; the later, without regard to the fact that he was also counsel for the receiver.' (Pages 588, 589 of 254 U. S., page 201 of 41 S. Ct., 65 L. Ed. 418.)

"We have no hesitancy in declaring the law to be that a president of an insolvent and failing corporation cannot traffic in its property to his advantage and to its disadvantage, or buy in debts against it at heavy discount and then assert them for full value. To the argument that it does not matter to the corporation *who owns its debts,* (italics ours) so it honestly owes them, and that it is immaterial to it whether its president gets them for nothing, as it does not have to pay any more than it actually owes in any event, the answer is, it does matter, for human nature is not so constituted that the same person can fairly represent opposing sides of the same question —cannot be both creditor and debtor. * * * The policy of the law is to insure fidelity of trustees to their trusts by making it impossible for them to profitably neglect or abuse them." (Italics ours.)

## Was the Appeal of This Case Taken in Time?

In this connection we will conclude this brief by a short discussion of this question. The law seems to be well settled that where a petition for reconsideration or rehearing has been entertained by the District Court in connection with an order made by it, even though on rehearing or reconsideration the District Court adhered to its former position, the time to appeal ran from the entry of the subsequent order instead of from the entry of the original order. In this case the Trustee petitioned the District Judge for a clarification of his earlier order. After a hearing thereon, the District Judge made a new order giving Bridgford a priority over the Oregon farmers and all other creditors.

In the *Matter of Brigantine Beach Hotel Corp.*, 197 F. 2d 296 at 300, the Court of Appeals for the Third Circuit discussed the timeliness of a similar appeal and the authorities on which its decision was based in the following language:

> "Though no motion for dismissal of the appeal from the order of November 29, 1951 was filed by appellees, the claim is made that the appeal from that order, filed January 28, 1952, was taken too late. There is no doubt that the district court ac-

cepted the petition for rehearing. The good faith of the debtor in seasonably urging reargument is not disputed. There is no suggestion that the district court abused its discretion in entertaining the petition or that any intervening rights were prejudiced by that action. Under these circumstances, it is plain that the time for the debtor to appeal from the order of November 29, 1951 was extended, even though the district court reaffirmed its former position, and ran anew from the denial of the petition for rehearing on January 28, 1952. Wayne United Gas Co. v. Owens-Illinois Glass Co., 300 U. S. 131, 57 S. Ct. 382, 81 L. Ed. 557; Bowman v. Loperena, 311 U. S. 262, 61 S. Ct. 201, 85 L. Ed. 177; Pfister v. Northern Illinois Finance Corp., 317 U. S. 144, 63 S. Ct. 133, 87 L. Ed. 146. Rule 59(b), 28 U. S. C. A., which generally requires a motion for a new trial to be served not later than ten days after the entry of the judgment has not changed this law. See 2 Collier on Bankruptcy (14th ed.), page 909 *et seq.* We think it equally settled, however, that in such a case as this, the debtor's appeal lies only from the original order on November 29, 1951. Here the debtor appealed not only from that order but also from the order of January 28, 1952. The latter order, being merely the denial of the petition for rehearing which had been entertained, is itself not the subject of appeal. Pfister v. Northern Illinois Finance Corp., *supra,* 317 U. S. at page 149, 63 S. Ct. 133; Klein's Outlet, Inc. v. Lipton, 2 Cir., 181 F. 2d 713, 714, certiorari denied 340 U. S. 833, 71 S. Ct. 59, 95 L. Ed. 612; United States v. Muschany, 8 Cir., 156 F. 2d 196, 197. Though the debtor has taken this appeal from both orders, we confine our review to the order of November 29, 1951."

## Conclusion.

The Bankruptcy Court is a court of equity. In the exercise of its equitable powers and in order to do equity and justice for all creditors, it may subordinate claims where claims are obtained through the violation of a fiduciary relationship. The facts of this case as to such violation are indeed aggravated. Mr. Bridgford had been the President, a Director and the principal stockholder of the debtor corporation, and at the time of the violation was one of the Court-appointed Managers. He was in court on November 4, 1949 at the time the Court stated that the debtor was in default under its Plan and that he would order an adjudication. He knew that the debtor corporation was hopelessly insolvent. With knowledge of these facts, he secured an assignment of the Debtor's Certificates from Mr. Hadley without any consideration whatsoever and subject only to Mr. Hadley's verbal suggestion that if any money was secured on these certificates that it should be used for the benefit of those who had invested money in the form of reorganizing the business. He immediately caused a petition to be prepared, together with an Order for the payment to himself of the sum of $25,-996.40 on said certificates, and for the payment to himself of $4,440.00 which he claimed under the Plan of Arrangement. He presented the petition and order to this Court the following Monday, November 7, 1949, without disclosing that he had secured the Debtor's Certificates for nothing, and the Court, assuming that they were entitled to priority, was prevailed upon to sign the Order. This was done without a hearing and without notice or knowledge on the part of creditors or their counsel. Mr. Bridgford, as a court-appointed Manager, immediately drew a check in favor of himself for the total sum of $30,436.40. He also drew checks for the other amounts set forth in the Order. The following day the Order of Adjudication was entered and the Trustee on qualifying found the munificient sum of approximately $60.00 left in the bank account. These facts, as we have stated, present an aggravated case of over-reaching and abuse of a fiduciary relationship by a Court-appointed fiduciary. Such conduct cannot be condoned. We respectfully submit that since Mr. Bridgford acquired the Certificates of Indebtedness for nothing, it would be inequitable to allow his claim to participate in the distribution of funds which were made available through the processing of foodstuffs for which the farmers and other creditors who produced the same have not been paid. It is the opinion of counsel and the trustee in this matter that to permit such an unjust enrichment to a fiduciary under the facts of this case would be shocking and unconscionable.

We respectfully submit that both Orders of the District Court should be reversed, and the Order of the Referee subordinating Mr. Bridgford's claim be affirmed.

Dated this 7th day of February, 1956.

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